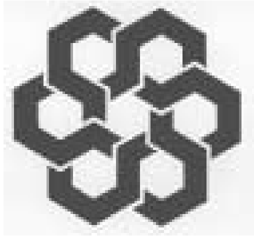

International Accounting Standards Board®

Press Release

31 March 2004

IASB ISSUES STANDARDS ON
BUSINESS COMBINATIONS, GOODWILL AND INTANGIBLE ASSETS

The International Accounting Standards Board (IASB) today issued International Financial Reporting Standard 3 *Business Combinations* (IFRS 3), and revised Standards IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*.

The IASB announced in July 2001 that it would undertake a project on Business Combinations as part of its initial agenda. The project's objective is to improve the quality of, and seek international convergence on, the accounting for business combinations and for goodwill and intangible assets. The project has a number of phases. IFRS 3, together with the revised versions of IAS 36 and IAS 38, has been issued as part of the first phase.

The main features of the new and revised Standards are:

- all business combinations within the scope of IFRS 3 must be accounted for using the purchase method. The pooling of interests method is prohibited.
- costs expected to be incurred to restructure an acquired entity's (or the acquirer's) activities must be treated as post-combination expenses, unless the acquired entity has a pre-existing liability for restructuring its activities.
- intangible items acquired in a business combination must be recognised as assets separately from goodwill if they meet the definition of an asset, are either separable or arise from contractual or other legal rights, and their fair value can be measure reliably.
- identifiable assets acquired, and liabilities and contingent liabilities incurred or assumed, must be initially measured at fair value.
- amortisation of goodwill and intangible assets with indefinite useful lives is prohibited. Instead they must be tested for impairment annually, or more frequently if events or changes in circumstances indicate a possible impairment.

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One of the primary objectives of the subsequent phases of the project will be to eliminate remaining differences between International and national standards on business combinations. Matters to be addressed include:

- issues related to applying the purchase method of accounting. This is being run as a joint project with the US Financial Accounting Standards Board (FASB).
- the accounting for formations of joint ventures and business combinations involving entities under common control.
- possible applications for 'fresh start' accounting.

Introducing the Standards, Sir David Tweedie, IASB Chairman, said:

> "Accounting for business combinations diverged substantially across jurisdictions. IFRS 3 marks a significant step towards high quality standards in business combination accounting, and in ultimately achieving international convergence in this area. Although many of the requirements are consistent with standards issued in Canada and the United States during 2001, the IASB has drawn on requirements in other jurisdictions when it believed a higher quality solution existed. This project is a good example of how convergence can and should work—for instance, the FASB is reconsidering its own standards on the treatment of in-process research and development projects that are acquired in a business combination, and restructuring costs that are expected to be incurred as a result of a business combination."

The primary means of publishing International Financial Reporting Standards is by electronic format through the IASB's subscriber Website. Subscribers are able to access the standards published today through "online services". Those wishing to subscribe should contact:

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United Kingdom. Tel: +44 (0)20 7332 2730, Fax: +44 (0)20 7332 2749,
email: publications@iasb.org Web: www.iasb.org.

Printed copies of IFRS 3 *Business Combinations* (ISBN 1-904230-45-8), and of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets* (ISBN 1-904230-53-9) will be available shortly, at £15 each including postage, from IASCF Publications Department.

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NOTES TO EDITORS

Summary of the Standards

1. IFRS 3 deals with the accounting for business combinations and the ongoing accounting for goodwill acquired in business combinations—it replaces IAS 22 *Business Combinations*. The revisions to IAS 36 and IAS 38 are primarily concerned with:

   - the form of the impairment test for goodwill;
   - the accounting for intangible assets, including in-process research and development projects, acquired in business combinations; and
   - determining the useful life and amortisation of intangible assets.

   The IASB's intention in revising IAS36 and IAS 38 was *not* to reconsider all of the requirements in those Standards.

2. The main requirements of IFRS 3 are:

   (a) consistently with the prohibition of the pooling of interests method in Australia, Canada, New Zealand and the United States, all business combinations within the scope of IFRS 3 must be accounted for using the purchase method.

   (b) in applying the purchase method, an acquirer must not recognise provisions for future losses or other costs expected to be incurred as a result of the business combination. Therefore, unless an acquired entity has, at the acquisition date, an existing liability for restructuring its activities, costs expected to be incurred as a result of the business combination to restructure the activities of the acquired entity (or the acquirer) should be treated as post-combination expenses. This is consistent with the requirements of UK Financial Reporting Standard FRS 7 *Fair Values in Acquisition Accounting*.

   (c) in applying the purchase method, an intangible item acquired in a business combination, including an in-process research and development project, must be recognised as an asset separately from goodwill if it meets the definition of an asset, is either separable or arises from contractual or other legal rights, and its fair value can be measure reliably. Except for the treatment of in-process research and development projects and the requirement for fair value to be reliably measurable, this is consistent with requirements in Canadian and US standards.

(d) the identifiable assets acquired, and liabilities and contingent liabilities incurred or assumed, must be initially measured at fair value. This requirement eliminates an option that existed in IAS 22. Under that option, an acquirer could elect to measure an acquired identifiable item at its fair value, or at a mixture of its fair value and pre-combination carrying amount. For example, assume entity A acquires a 60% ownership interest in entity B, and that one of entity B's assets is a building with a carrying amount of 1,000 and fair value of 2,000. Under IAS 22, entity A could elect to initially measure the building at 2,000 (fair value), or at 1,600 (fair value for the 60% ownership interest acquired, plus pre-combination carrying amount for the 40% ownership interest that continues to be held by parties other than A). IFRS 3 requires entity A to initially measure the building at 2,000 (fair value)

(e) consistently with requirements in Canadian and US standards, goodwill acquired in a business combination must not be amortised. Instead it must be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired. As a result, income statements would not be charged, unless goodwill is determined to be impaired. IAS 22 required goodwill to be systematically amortised over its useful life. There was a rebuttable presumption that its useful life could not exceed twenty years. The following arguments are often put forward in support of amortising goodwill:

- amortisation is a method of allocating the cost of goodwill over the periods it is consumed, and is consistent with the approach taken to other intangible and tangible fixed assets that do not have indefinite useful lives.
- acquired goodwill is an asset that is consumed over time and replaced with internally generated goodwill. Amortisation therefore ensures that the acquired goodwill is written off and no internally generated goodwill is recognised in its place. This is consistent with the general prohibition on recognising goodwill generated internally by an entity.
- the useful life of acquired goodwill cannot be predicted with a satisfactory level of reliability, nor can the pattern in which that goodwill is consumed be known. Therefore, amortisation over an arbitrary period of time is the only practical solution to an intractable problem.

However, the useful life of acquired goodwill and the pattern in which it diminishes generally are not possible to predict, yet its amortisation depends on such predictions. As a result, the amount amortised in any given period can at best be described as an arbitrary estimate of the consumption of acquired goodwill during that period. In addition, both anecdotal and research evidence supports the view that the amortisation charge for goodwill has little, if any, information value for most users of financial statements, and that an impairment-only model provides users with more useful information. See, for example, *Goodwill Amortization and the Usefulness of Earnings*,[1] which describes the findings of empirical research undertaken in response to the FASB's decision to eliminate goodwill amortisation. Extracts from the authors' summary of the article are provided below:

> "Analysts frequently face the problem of how to consider goodwill amortization in their financial analysis. For many years, financial

[1] Jennings, LeClere and Thompson, The Financial Analysts Journal (published by the Association for Investment Management and Research), September/October 2001

statement preparers and users have criticized the accounting requirements to amortize purchased goodwill against revenues over a period not to exceed 40 years. Critics have argued that goodwill may not decline in value and that, even if it does, the arbitrary amounts recorded periodically as goodwill amortization are unlikely to reflect that decline. In this view, goodwill amortization simply adds noise to earnings, thereby reducing their usefulness to investors. Accounting standard setters, in contrast, have until recently maintained that goodwill is likely to be a wasting asset in most circumstances and that recording goodwill amortization makes reported earnings more useful to investors by reflecting its decline in value. We provide empirical evidence as to which of these views is more consistent with the way in which investors price securities.

"To investigate this issue, we document the extent to which variation in stock prices is explained by earnings before goodwill amortization and by reported earnings, which includes goodwill amortization. Our analysis [is] based on a large sample of publicly traded companies reporting purchased goodwill in the six-year period of 1993-1998.

"Our results find evidence consistent with the criticisms of the previous accounting rules for goodwill. In each year and for the six-year period as a whole, earnings before goodwill amortization explain more of the variation in share prices than reported earnings, and for each year, the difference in explanatory power is statistically significant. Moreover, … [our] finding[s] strongly suggest that goodwill amortization merely adds noise to reported earnings. Overall, these results indicate that the recently adopted reporting rules for purchased goodwill are likely to increase the usefulness of earnings as a summary indicator of share value."

(f) if the acquirer's interest in the net fair value of the acquired identifiable net assets exceeds the cost of the business combination, that excess (sometimes referred to as negative goodwill) must be recognised immediately in the income statement as a gain.

3. The IASB and the FASB, through their joint phase II Business Combinations project, are working to eliminate remaining differences in the application of the purchase method between International Financial Reporting Standards and US accounting standards. As a result of those efforts, the FASB has tentatively agreed to amend its standards to converge with the requirements outlined in 2(b), (d) and (f) above. The FASB has also tentatively agreed to amend its standards to converge with the treatment in International standards of in-process research and development projects acquired in business combinations.

4. The main revisions to IAS 36 and IAS 38 are:

   (a) to require goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate a possible impairment. This is consistent with Canadian and US requirements.

   (b) to prohibit reversals of impairment losses for goodwill. This is consistent with Canadian and US requirements.

(c) to require an intangible asset to be treated as having an indefinite useful life when, based on an analysis of all relevant factors, there is no foreseeable limit on the period over which the asset is expected to generate net cash inflows for the entity. An intangible asset with an indefinite useful life must not be amortised, but must instead be tested for impairment annually, or more frequently if events or changes in circumstances indicate a possible impairment.. This is consistent with requirements in Canadian and US standards.

(d) to require disclosure of a range of information for each cash-generating unit that includes within its carrying amount a significant amount of goodwill or intangible assets with indefinite useful lives. That information is concerned primarily with the key assumptions used to measure the recoverable amounts of the units. The non-amortisation of goodwill and intangible assets with indefinite useful lives increases the reliance that must be placed on their impairment tests. However, the nature of impairment tests means that the carrying amount of a non-amortised asset, and the related assertion that the asset is not impaired, would often be supported only by managements' projections. The IASB has therefore included these disclosure requirements to improve the transparency and reliability of impairment tests for goodwill and intangible assets with indefinite useful lives.

Summary of due process

5. In December 1998, IASC (the IASB's predecessor body), along with other members of the G4+1,[*] published for public comment a Position Paper *Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence.* The Paper argued that the use of a single method of accounting for business combinations is preferable to two or more methods, and that the appropriate method is the purchase method. The Paper noted that its recommended approach was consistent with standards in Australia and proposed (now existing) standards in New Zealand, and recommended that the IASC and other G4+1 members should consider amending their standards. In June 2001, the FASB issued Statement of Financial Accounting Standards No. 141 *Business Combinations*, and the Canadian Accounting Standards Board issued Section 1581 *Business Combinations*. Both those Standards prohibit the use of the pooling of interest method of accounting for business combinations, and instead require all business combinations to be accounted for by applying the purchase method. In July 2001, the IASB, after consulting its Standards Advisory Council (SAC), decided that a project to achieve convergence of existing standards on business combinations should be added to the Board's agenda.

6. In December 2002 the IASB published Exposure Draft (ED) 3 *Business Combinations* and an Exposure Draft of Proposed Amendments to IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. As part of its consultative process, the IASB conducted field visits during the comment period for the Exposure Drafts. The IASB's main purpose in making the field visits was to improve its understanding of the practical implications of some of its proposals on the accounting for goodwill and intangible assets. The field visits involved IASB members and staff in meetings with 41 companies in Australia, France, Germany, Japan, South Africa, Switzerland and the United Kingdom. IASB members and staff also took part in a series of round-table discussions with auditors, preparers, accounting standard-setters and regulators in Canada and the United States

[*] The G4+1 comprised members of the national accounting standard-setting bodies of Australia, Canada, New Zealand, the UK and the US, and IASC.

on implementation issues encountered by North American companies during first-time application of the US standards SFAS 141 *Business Combinations* and SFAS 142 *Goodwill and Other Intangible Assets*, and the equivalent Canadian Handbook Sections, which were issued in June 2001.

7. In June 2003 the IASB began reviewing the outcome of those discussions and the field visits, and to analyse the comment letters received on the Exposure Drafts. As a result, the IASB agreed to a number of changes from the proposals. The three most significant relate to:

   (a) the manner in which goodwill impairment losses are measured;

   (b) the criteria for recognising separately from goodwill intangible assets acquired in business combinations; and

   (c) the information required to be disclosed about cash-generating units that include within their carrying amounts goodwill or intangible assets with indefinite useful lives.

8. Of these three main changes, the most significant relates to the manner in which goodwill impairment losses are measured, Field visit and round-table participants were asked a series of questions aimed at aiding the IASB's understanding of, amongst other things, the practical challenges that entities would face in performing the 'two-step' goodwill impairment test proposed in the IAS 36 Exposure Draft. The second step of the test would have involved comparing the carrying amount of the goodwill in a cash-generating unit with the goodwill's implied current value. Field visit participants responded as follows:

   (a) to measure the implied current value of goodwill the majority of them would be compelled to engage independent valuers to identify and determine the necessary fair values of all/most/many identifiable assets, with intangible assets (particularly internally generated intangible assets) likely to be the most problematic. These valuations typically would need to be undertaken on an extremely wide-scale and involve significant cost.

   (b) the scale on which the necessary valuations would need to be performed by entities that are multi-segmented manufacturers operating multi-product facilities servicing more than one unit would make the second step of the impairment test impracticable, both in terms of cost and timeliness.

   After considering these and other comments, the IASB concluded that the complexity and costs of applying the 'two-step' goodwill impairment test proposed in the Exposure Draft would outweigh the benefits of that approach. The IASB therefore agreed to retain the approach previously in IAS 36 to measuring impairments of goodwill.

The IASB

9. The IASB, based in London, began operations in 2001. It is funded by contributions collected by its Trustees, the IASC Foundation, from the major accounting firms, private financial institutions and industrial companies throughout the world, central and development banks, and other international and professional organisations. The 14 IASB members (12 of whom are full-time) reside in nine countries and have a variety of professional backgrounds. The IASB is committed to developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements. In pursuit of this

objective, the IASB cooperates with national accounting standard-setters to achieve convergence in accounting standards around the world.